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Review of Scottish Business Surveys

Overall

Once again the majority of surveys of Scottish business, in common with UK and European surveys, continued to highlight ongoing and deepening concerns as to the sovereign debt crisis in the Euro zone and signs of a more general global slowdown. These, together with forecasts of lower rates of growth in 2012, continuing consumer insecurity and pressures on household spending continued to dampen business confidence and activity. However, the Scottish Engineering Quarterly Review (Q1 and Q2 2012), Oil & Gas UK Index (q1 2012) and Aberdeen & Grampian Chamber of Commerce Oil and Gas Survey (Spring 2012) suggest a contrasting view for these sectors, and one of rising orders, activity and confidence – although export orders continue to remain weak in Scottish Engineering in marked contrast to this sense of a slowing down. Additionally, Visit Scotland occupancy data shows fewer signs of a slowdown, although Scottish Chamber data suggests occupancy rates may well be sustained by more room rate reductions, and widespread discounting continues in retail as the latest Scottish Retail Consortium figures for May indicate continuing weak sales trends.

PMI and Scottish Chamber data suggest a modest improvement in activity in the first quarter, but the monthly PMI surveys (both UK and Scotland) for April and May suggest a slowing down in activity, the extent to which this reflects seasonal and other differences between the first half of 2011 and 2012 is unclear, equally unclear is the outcome of the current financial issues in the Euro zone, reported elsewhere in this Commentary.

The impact of government spending cuts and reorganisation of public services continue to adversely influence consumer behaviour, and business activity and sentiment in Scotland and in the rest of the United Kingdom. Within Scotland there is the additional uncertainty over the referendum and calls from a number of companies for an informed debate on the key questions.

Oil and gas services

Following the 2011 Budget business confidence amongst operators and contractors remained stagnant, with little change evident in the first three quarters of 2011 (Oil and Gas UK Index Q3 2011), and, as we noted in the previous Commentary, the number of exploration and appraisal wells started in Q3 2011 declined to 12 compared to 21 in Q3 2010, and Deloitte reported offshore drilling levels falling to the lowest level since 2003, total output fell sharply in 2011 due to a combination of long term trends and exceptional issues. Whilst a number of significant developments were announced in 2011 which suggested continuing high levels of investment in the sector these had received approval prior to the 2011 Budget changes.

By the end of 2011 there were signs (Oil & gas UK Q4 2011 Index) that confidence was returning slowly to the offshore oil and gas industry reflecting sustained high oil prices, but with some concerns amongst contractors that marginal projects were being delayed as operators focus on larger developments. Confidence continued to strengthen through the first half of 2012 reflecting both global and UK developments. Globally the outlook for the oil and gas sector in 2012 remains positive, although with continuing geo political and economic uncertainties. In February 2012 the International Energy Agency forecast growth of 0.9% in the global demand for crude, a further reduction in its forecast from previous months. The outlook reflects growing demand in developing nations (2.8% according to the IEA) and relatively flat consumption in most advanced economies, with high oil prices threatening to dampen activity in developed economies. Brent crude remained within the range of \$100 - \$125 per barrel through the early part of 2012, but has eased to below \$100 per barrel following from concerns as to a weakening in global demand. Increasingly there is the view that in the longer term the global development of shale gas production offers the possibilities of transforming energy policies and leading some analysts to contemplate a reduction in energy prices and posing more questions as to the scale of subsidies necessary to support the continued development of renewables. Wood Mackenzie's review of the UK upstream industry (published January 2012) predicted continuing high levels of investment through to 2014 – due to stable high oil prices, and anticipated an 'increasing appetite for UK exploration acreage' but commented on the additional charges introduced in the 2011 budget as 'highlighting the instability of the UK fiscal regime', a theme noted in Oil & Gas UK's 2011 Economic Report, and evident in the increased applications for licences to drill in the UKCS. The latest licensing round for oil and gas drilling has seen a total of 224 applications submitted, the largest number since offshore licensing began in 1964, and 37 more than the previous round's high of 187.

Oil & Gas UK were successful in initially lobbying and subsequently persuading the Government to make changes, valued at some £3 billion, to decommissioning tax relief, the existing field allowance scheme and a number of other changes in the 2012 Budget, but as the UKCS moves further into maturity further fiscal changes and tax relief will be essential to maximise recovery and stability of the fiscal regime will be critical. These changes contributed to rising confidence as to both UK and internationally based activities being reported both by Aberdeen & Grampian Chambers 16th Oil and Gas Survey and Oil & Gas UK Q1 2012 Index (both published May 2012). Both surveys reported confidence amongst contractors increasing to record levels reflecting a number of major projects as well

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as growth in export markets, whilst optimism increased more modestly amongst operators. Nevertheless, the legacy of the 2011 budget lingers in terms of perceptions as to the potential instability of the UK fiscal regime, and Aberdeen & Grampian Chamber's Oil and Gas survey noted the outturn in the net trends in investment by contractors was lower than had been anticipated prior to the 2011 budget. The demand for staff continued to improve, but this was more noticeable amongst larger and international companies, reflecting higher levels of activity internationally. Overall investment continued to be more directed towards developing new markets, cost reduction and staff development than towards other areas, but there were signs of respondents expanding and developing their UKCS and internationally based activities in Aberdeen.

Private sector

The Scottish private sector lost momentum according to the Bank of Scotland PMI (May 2012) as output and new business rose marginally, suggesting a slowing in the private sector as 'the Scottish economy is struggling to maintain growth momentum in the global slowdown' and continuing euro zone difficulties. The Lloyds TSB England Regional PMI for May noted a similar slowdown on the rate of business growth across the English regions. The average output index for England eased to 52.3 (a six month low) whilst for Scotland the index slipped to 50.8, a 17 month low and was the second lowest region (after the North West).

Production

The latest Business Monitor from LloydsTSB Scotland reported that recovery in the Scottish economy has yet to pick up pace. In the three months ending February 2012, 29% of the firms surveyed increased turnover, 36% experienced static turnover and 35% experienced a decrease. This net balance of -6% is a slight deterioration from the -3% of the previous quarter but a substantial improvement on the -20% of the same quarter one year ago. Overall turnover for production firms in the three months to the end of February this year was a net balance of +2%; a fall on the +9% of the previous quarter but significantly better than the -15% of the same quarter one year ago. The Bank of Scotland PMI for April noted manufacturing production falling slightly.

Manufacturing

The Index of Manufactured exports for the fourth quarter of 2011 was unchanged (0.0% growth) (compared to 0.2% in the third quarter) and grew on an annual basis by 4.8%. Food and Drink, Metal Products, Engineering and allied industries registered rises over the quarter. Once again whilst there were differences between the business surveys in the interpretation of trends there was more agreement in surveys of a slowing down in manufacturing activity in the second quarter of 2012. The exception to this pattern was Scottish Engineering reports for both Q1 and Q2 2012 – although official data from the Index of manufactured exports had noted a stronger trend for engineering and allied industries (albeit for the fourth quarter of 2011). The Purchasing Managers Index (PMI) conducted by The Bank of Scotland concluded that the Scottish private sector economy lost momentum as activity rose only marginally and new business inflows were near stagnation in May, although manufacturing reported a modest growth reflecting new export orders. The Scottish economy continues to be affected by the slowdown in Eurozone economies and the more general global slowdown.

The Scottish Chambers' Business Survey (SCBS) reported that business confidence improved in Q1 with more than 80% of firms reporting no change/improved confidence levels; and similarly the Scottish Engineering Review in its first quarter survey outlined that business confidence was proving to be 'resilient if not optimistic'. The CBI reported a return to optimism for Scottish manufacturers (the highest for 18 months) fuelled by strengthening export order books coupled with confidence over future overseas demand.

For respondents to The Scottish Engineering Review trends in total new and export orders returned to a positive net balance after a quarter of decline with only small firms continuing to report downward trends, and SCBS manufacturing firms reported that the trend in total new orders improved to the highest net balance since Q4 2010 and the trend in total new sales also improved. Export orders rose strongly in Q1 and are expected to rise further despite concerns over trading conditions in many overseas markets for CBI respondents. For SCBS firms the outturn in total orders was significantly better than had been expected; the rising trend in export orders, which until a declined last quarter, had been a feature of the past four quarters, resumed and respondents now anticipate an increase. The Scottish Engineering review also reported a marginal rise in export orders and predict a further increase.

The CBI industrial trends survey noted that the return in business confidence had not yet lead to improvements in investment intentions. SCBS firms claimed that although continuing to rise, trends in investment in plant/machinery remained weak during quarter one for a net balance of firms. New investment was again mainly directed towards replacement or to improve efficiency. Capital investment plans among respondents to the Scottish Engineering Review rose for the seventh consecutive quarter.

Employment trends improved among SCBS firms, although more than two thirds reported no change and remained upbeat for respondents to the Scottish Engineering Review.

Construction

Wide swings in activity have been reported by the Markit/CIPS UK construction PMI for 2012. The report for February reported a sharp increase in growth driven mainly by commercial property construction and a return to modest growth in domestic house construction. Strong growth of new orders was seen as contributing to a rise in construction sector activity in March and to rising confidence. The Markit/CIPS UK construction PMI reported further solid rises in construction output and new work, but at reduced rates in April, with moderate job creation and input cost inflation at its lowest since March 2010. Construction output growth continued to slow in May and confidence in the business outlook dropped sharply since April. Balfour Beatty has been reported as having put considerable numbers of staff on notice, reflecting 'difficult headwinds' in the sector and Carillon is reported as undergoing restructuring. Comments from the sector note 'suicide bids by competitors' a rise in the number of bids for work from Ireland and problems affecting the sector due to the winding down of Olympic projects and other infrastructure projects, In April Persimmon noted some signs of an improvement in private house building especially at the higher end of the market. Official data showed sharp drop in construction output in Q1 2012.

In Scotland the Construction Skills report had forecast 2012 as a further year of declining output with growth not expected to return to the sector until 2013. It is estimated that some 200 Scottish building firms went into liquidation over the past four quarters. These trends were supported by evidence from Scottish Chamber construction respondents indicated business confidence remained weak in the first quarter of 2012, with only 8% of firms reporting a rise. Firms, on balance, were less pessimistic than in recent first quarters. The latest Scottish Construction Monitor conducted by the Scottish Building Federation members (SBF) for Q1 2012 reported that the general confidence rating declined by 9 points and now stands at -28 (6 points below the level at Q1 2011).

As anticipated by respondents in Q4 2011 the rate of decline in construction orders slowed in Q1 with 40% of firms reporting an increase in new orders, in part a possible reflection of increased work arising from the winter, repair and maintenance work was seen as the most positive outlook in the construction sector in the latest Scottish Construction Monitor. Private commercial orders showed the most improvement (although the net balance remained negative). All trends are expected to decline further in Q2. More than three-quarters, compared to over 80% of respondents in the previous survey, reported working below capacity. Cash flow trends are expected to level out, whereas turnover and profitability are expected to be weak over the next 12 months together with continued pressure on margins. Average capacity used, remained at 75%. The Scottish Building Federation chief executive commented that '2012 looks set to be a particularly bad year for public sector construction output…the annual rate of new house building in Scotland is now at the lowest since current records began in 1997'.

The downward trend in employment eased in Q1 for SCBS firms and once again few recruitment difficulties were evident. Average pay increases rose from 1.8% in Q4 to 2.5%. The Scottish Construction Monitor concluded that most firms expect employment to remain unchanged although a third of respondents expected the number of people they employ to decline and only 9% expect a rise.

The service sector

The Lloyds TSB Scottish Business Monitor (Q 1 2012), reported that service businesses did not experience such benign conditions (compared to the production sector), with the overall net balance for turnover for the three months ending February at -11% - worse than the -8% of the previous quarter but, like the production sector, much improved from the -22% of the same quarter one year ago. In contrast the Bank of Scotland Scottish private sector PMI for March noted stronger services growth due to stronger travel and leisure businesses, but the UK pattern was one of slowing growth, with upside limited by difficult trading conditions and cutbacks in Government spending. The Bank of Scotland PMI for April noted stronger growth in the services sector

Retail distribution

Teasing out the trends in retail sales continues to be problematic. Once again comparisons between 2011 and 2012 have to factor in marked differences in the weather (March 2011 snow and March 2012 good weather), differences in the dates for Easter, the effect of extra public holidays and 'panic' buying of fuel. Additionally structural changes continue to affect the sector. Tesco increasingly plans to focus on smaller stores and to stress on line business (both click and collect and delivery) and other supermarkets are expected to follow suit. In contrast Sainsbury's reported continuing to increase floor space in Scotland. The Edinburgh retail trade is reported as continuing to be badly affected by the tram works with a 100 businesses in Princes Street to get rates reductions and over 220 Edinburgh shops are reported to have lodged compensation claims.

The overall retail picture in Scotland appears to be one of an underlying lack of consumer confidence although the Retail Sales Index for Scotland (Q1 2012) noted a 0.7% rise in the volume of retail sales and a 0.9% increase in value (both at constant prices). The Scottish Retail Consortium and retail respondents to the Scottish Chambers' survey continued to report harsh trading conditions.

The February UK retail figures (British Retail Consortium) suggested any revival in retail sales remained illusory as increases in sales continued to lag behind inflation and non-food sales weakened further. Overall consumers were reported as buying less than a year ago and discounts were continuing to reduce margins. The Scottish retail (value) figures for February 2012 echoed the UK trends, and were down 0.6% on a year ago, the weakest trends since the survey began in 1999, (this reflected a rise of 3.4% in food sales but a decline of 4.4% in non-food sales).

The Scottish Retail Consortium figures for March showed an increase of 1.8% year on year, the first positive figures since Christmas, but there was much to suggest this was a weather related boost. A number of retailers continued to face a struggle for survival as sales often remain reliant on deep discounting. The failure of Clinton indicates the problems of increased competition from supermarkets and on line providers together with high rents. Likewise Scottish Chambers' retail respondents reported poor sales trends in the first quarter of 2012.

Scottish retail figures sales values for April were down 4.1% on same month a year ago, but a year ago good weather and royal wedding boosted sales. Like-for-like sales were down 5.2% compared to a year ago when they had risen 3.4%. Non food sales were down 7.3% compared to a year. In May sales values rose by only 0.1% compared to the same month of 2011 (sales in May 2011 were extremely weak at 1.1% down on sales for May 2010).

Conditions in the retail sector among SCBS firms did not improved significantly during the first quarter with declining consumer confidence and sales trends easing only marginally. Only 11% reported and only 6% expect increased sales, as continuing concerns over consumer confidence remain evident. Cost pressures remain severe, although those concerned with increasing suppliers costs eased from 69% to 66%. Transport costs and utility costs continued to be of concern. Pressures on margins remain widespread with over half expecting declining profitability and turnover over the next year. Labour market activity continued to decline but the rate of decline was the slowest since 2007; however a third of firms expect a decline during the second quarter. Recruitment problems eased. Only 6% of firms reported increasing pay, and the average increase remained at 2.5%.

The CBI's Distributive Trades survey (UK wide) for May noted that retail sales remain below average for the time of year but that optimism had improved. Retailers expect sales volumes to grow further in May but many remain cautious with unemployment, slow wage growth and weak consumer confidence impacting on future sales.

Tourism

The latest PKF's monthly survey of three and four star hotels (March 2012) indicated occupancy in Scotland fell by 0.1% during March raising some concerns as to the fragility of the Scottish hotel sector. Aberdeen was reported as again outperformed the rest of Scotland's cities with an increase in occupancy of 0.1% to 75.8%, while revenues rose there by 7.4% to £58.74. Glasgow also fared well during March, with an increase in room yield of 4.6% to £45.99 despite a fall in occupancy of 1.9%. In contrast Edinburgh recorded a drop of 3.9% to 66.4%, while revenue fell by 8.9% to £43.66. As the report authors noted "It would be unwise to read too much into one month's figures but it is clear that the sector continues to face considerable instability, mirroring the uncertainties in the wider economy. There is no reason to assume that 2012 will be a great year for Scottish hotels at this stage."
In contrast a different image was reported by the Scottish Hotel Occupancy Surveys, January and February 2012 bed and room occupancy was fractionally higher than for the comparable months in 2011 and 2010 – with Aberdeen & Grampian and Dundee & Angus reporting improvements in both room and bed occupancy compared to a year earlier. March figures were better than the preceding three years, in both January and March the highest occupancy figures were recorded by Edinburgh & the Lothians and Glasgow and Clyde areas. The latest data as to trends in visitor numbers to tourist attractions (2011) indicated that 9 of the top 10 visitor attractions were located in the central belt, differences between urban and rural tourism was a theme noted by Scottish Chambers in their comments as to the results for Q1 2012. Scottish Chamber tourism respondents reported a decline in business confidence eased during the first quarter of 2012, although was significantly lower compared to Q1 2011.

The rising trend in total demand ended during Q1 for a net balance of SCBS tourist respondents although a rise is expected in the second quarter. The decline was not as severe as had been forecast by respondents from the previous survey.

SCBS average occupancy declined (from 56.8% to 53%, broadly comparable to Scottish Hotel Occupancy Survey figures) although was marginally better compared to the same quarter a year ago. During the three months to the end of March 2012, trends in bar/restaurant trade and for conference/ function facilities continued to decline.

Almost half of hotels reported reducing average room rates and the widespread pattern of 'special offers' seems set to abate slightly during quarter two with a net balance of 9% expecting to increase room rates. Two-thirds, compared to three-quarters in the previous quarter, reported that the lack of tourist demand remained the primary business constraint; poor transport infrastructure, high fuel costs and weak marketing of their area also remained a concern to hotels. 43% (compared to 48% in the fourth quarter) of SCBS firms sought to recruit staff; employment trends, as forecast declined in quarter one and the declines were loosely as had been expected. A net balance of 23% expect a rise in total employment levels in Q2 2012.

Logistics and wholesale

Data from the Scottish Chambers' Business Survey showed that the problems in the Scottish wholesale distribution sector largely continued. Business confidence amongst Scottish wholesale respondents eased further with fewer than half of firms reporting a decline in business confidence. Business confidence was once again considerably lower compared to one year ago. A net balance of almost 40% of firms in the previous survey had expected a decline in sales however the outturn was -12%;

and a net balance expect a further decline in the second quarter of 2012.

More than 90% of wholesalers continued to report increased pressures from transport costs. Cost pressures generally eased during the three months to the end of March. More than three-quarters of firms expect to increase prices over the next three months, and cash flow trends remain weak. Once again concerns over turnover and profitability remained. Once again most firms reported no change to investment plans; nevertheless there appears to have been a marginal decline.

Wholesale respondents on balance recruited staff during the first three months of 2012 although a net balance expected to shed staff in Q2. Fewer than a third sought to recruit staff; largely for replacement. The average pay increase in Q4 was 3.4% compared to 3% in Q4.

Outlook

The signs of a weak recovery in the UK and Eurozone economies in the first quarter tended to fade in April and May, with the exception of the engineering and oil & gas sectors. Continuing consumer insecurity and reduced domestic spending, combined with the impact of government spending cuts again dampened business confidence and activity. The pickup in activity in construction in Q1 2012, reported by some surveys appeared to be based more on repair and maintenance rather than new build. Once again corrosive effects of uncertainty both in Europe and at home coupled with weak consumer confidence will combine to make 2012 a difficult year for Scotland, as evidenced by rising numbers of company failures, takeovers and mergers.

At the end of 2011 the trends in demand and activity in construction were largely unchanged from a year ago, with widespread declining trends and pressures on margins being widely reported, once again the exceptional weather conditions are likely to impact on trends, especially in the first quarter given the need for repair and renewal following the winter storms. In tourism the outturn was weaker than anticipated and little changed from a year ago.

Marked differences in the weather, public and other holidays affected patterns in both the retail and tourism sectors and compound the difficulties in assessing the impact of the slowdown in economic activity on consumer spending. The impact of the Olympics on overall tourism numbers in the UK again remains unclear, as is the impact on the Scottish tourism sector. However, as we noted in the previous Commentary there is much to suggest that weak consumer confidence and spending will continue at adversely affect these sectors through 2012.

Once again labour market activity remained subdued in most sectors, except engineering and the oil and gas sector. The SCBS (q1) noted that the trends in all sectors,

except tourism, were better than anticipated three months ago, rising trends in employment were reported in manufacturing and in construction and retail the declining trends eased in the first quarter. Once again recruitment difficulties remained subdued in all sectors.

Pay increases in the first quarter, reported by Scottish Chamber respondents ranged from 2.5% in construction and retail to 3.8% in tourism. Over the past year pay increases have averaged 2.6% in construction, 2.95% in manufacturing and 3.3% in retail and tourism – well below the rate of inflation and implying real declines in household income.

Cliff Lockyer/Eleanor Malloy
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Current trends in Scottish Business are regularly reported by a number of business surveys. This report draws on:

1. Aberdeen & Grampian Chamber of Commerce Survey no 16 May 2012;
2. The Confederation of British Industries Scottish Industrial Trends Survey for the first quarter 2012;
3. Scottish Bulletin Index of Manufactured exports 4th quarter 2011;
4. Lloyds TSB Business Monitor Issue no. 57 for the quarter December 2011 – February 2012 and expectations to August 2012;
5. Markit/CIPS UK Construction PMI for February, March, April and May 2012;
6. Scottish Engineering's Quarterly Review Q1 and Q2 2012;
7. The Bank of Scotland Markit Economics Regional Monthly Purchasing Managers' Indices for February, March, April and May 2012;
8. Lloyds TSB England Regional PMI for May 2012;
9. The Scottish Retail Consortium's KPMG Monthly Scottish Retail Sales Monitors February, March, April and May 2012;
10. The Scottish Chambers of Commerce Quarterly Business Survey report for the first quarter of 2012;
11. Oil & Gas UK quarterly Index Q4 2011 and Q12012;
12. ONS Retail sales Q 1 2012;
13. Visit Scotland Occupancy Survey for December 2011, January, February and March 2012;
14. The Scottish Construction Monitor Q1 2012;
15. 2012-2016 Construction Skills Network